

No. 14735

**In the United States Court of Appeals
for the Ninth Circuit**

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ROBERT H. MILLER AND DORIS K. MILLER, RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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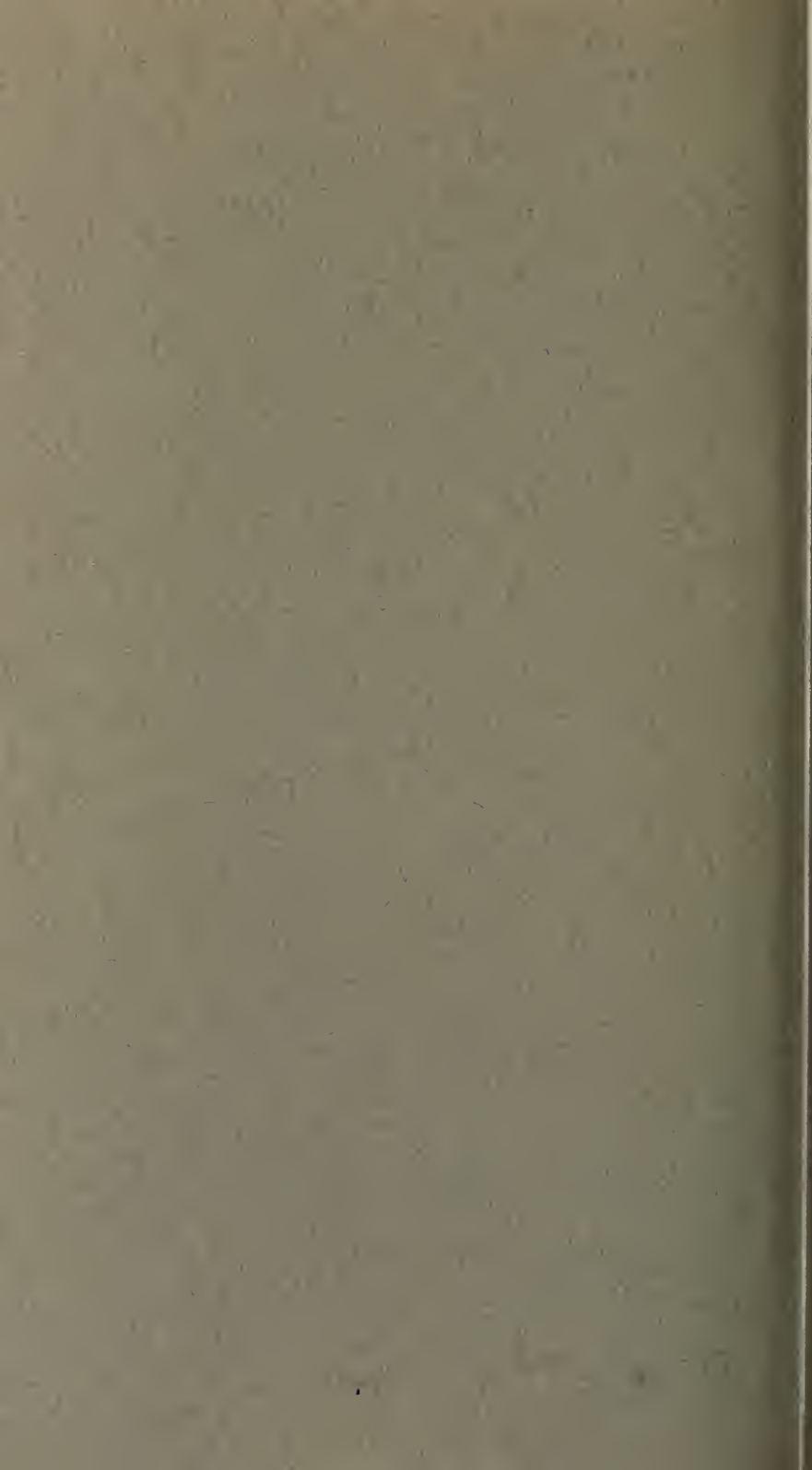
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December 12, 1952, the taxpayers filed a petition with the Tax Court for the redetermination of such deficiencies, under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 5-15.) The decision of the Tax Court redetermining and reducing in large part the deficiencies asserted by the Commissioner, as shown above, was entered on November 8, 1954. (R. 23.) The case is brought to this Court by petition for review filed by the Commissioner on January 28, 1955. (R. 55-58.) The jurisdiction of this Court is invoked pursuant to Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the first-year payments made by the taxpayer during the taxable years 1948 and 1949 for the acquisition of the non-competitive Government leases on oil and gas lands here involved constituted non-deductible capital expenditures recoverable only through depletion deductions, under the provisions of Section 23 (m) of the Internal Revenue Code of 1939, rather than ordinary and necessary business expenses deductible as statutory "rentals" under Section 23 (a) (1) (A) of the 1939 Code, as held by the Tax Court.

STATUTE AND REGULATIONS INVOLVED

These are printed in the Appendix, *infra*.

STATEMENT

The facts were stipulated (R. 24-54), and were found by the Tax Court accordingly. So far as pertinent here they are substantially as follows (R. 17-20):

The taxpayers are, and were during 1948 and 1949, husband and wife and residents of Los Angeles, California. They filed joint income tax returns, prepared on the cash receipts and disbursements basis, for the years 1948 and 1949 with the Collector for the Sixth District of California. (R. 17.)

Robert H. Miller, sometimes hereinafter referred to as the taxpayer, is a geologist and is, and has been, engaged in various enterprises in the oil and gas field. (R. 17.)

Under date of July 1, 1947, the taxpayer, I. W. Bosworth and Glenn C. Ferguson formed a partnership, with each having a one-third interest, known as I. W. Bosworth and Associates, and sometimes hereinafter referred to as the Bosworth partnership. Under date of August 1, 1948, taxpayer, I. W. Bosworth and Glenn C. Ferguson, formed another partnership, with each having a one-third interest, known as Robert H. Miller and Associates, and sometimes hereinafter referred to as the Miller partnership. Under date of May 1, 1949, taxpayer, I. W. Bosworth, Glenn C. Ferguson and J. N. Huber formed a third partnership, with each having a one-fourth interest, known as the Equity Oil Company, and sometimes hereinafter referred to as the Equity partnership. All the foregoing partnerships were formed for the purpose of acquiring oil and gas leases for investment and development. Each of the partnerships reported its income on the cash receipts and disbursements basis. (R. 18.)

During the taxable years involved herein, the above-mentioned partnerships acquired noncompetitive oil

and gas leases on United States Government lands. All of the leases were issued pursuant to the authority of the Mineral Lands Leasing Act, c. 85, 41 Stat. 437, Section 1, as amended by the Act of August 8, 1946, c. 916, 60 Stat. 950, Section 1 (30 U. S. C. 1952 ed., Sec. 181). Applications for such leases, accompanied by a filing fee of \$10, were made by the respective partnerships through their individual members, and the leases, when issued, were executed by the partnerships through their individual members, and on behalf of the United States Government by a properly authorized official. (R. 18-19.)

During its fiscal year ended January 31, 1948, the Bosworth partnership paid filing fees of \$173 in connection with applications made for noncompetitive oil and gas leases, and on noncompetitive oil and gas leases made first-year payments totaling \$8,652.22. In determining the amount of the taxpayer's distributive share of the partnership's loss for the partnership's fiscal year ended January 31, 1948, to be allowed as a deduction in his income tax return for 1948, the Commissioner determined that the fees and first year payments totaling \$8,825.22 were not allowable deductions. (R. 19.)

During its fiscal year ended January 31, 1949, the Bosworth partnership paid filing fees of \$333 in connection with applications made for non-competitive oil and gas leases, and on non-competitive oil and gas leases made first-year payments totaling \$30,972.08, or a total of \$31,305.38. During its fiscal period ended January 31, 1949, the Miller partnership paid filing fees of \$312 in connection with ap-

plications made for non-competitive oil and gas leases, and on non-competitive oil and gas leases, made first-year payments totaling \$5,384.50, or a total of \$5,696.50. During the period beginning May 1, 1949, and ended December 31, 1949, the Equity partnership paid filing fees of \$330 in connection with applications made for non-competitive oil and gas leases, and on non-competitive oil and gas leases made first-year payments totaling \$20,103.44, or a total of \$20,433.44. In determining the amount of the taxpayer's distributive share of the partnership loss from the foregoing partnerships to be allowed as deductions in the taxpayers' income tax return for 1949, the Commissioner determined that such filing fees and first-year payments were not allowable deductions. (R. 19-20.)

The non-competitive oil and gas leases obtained by the various partnerships and involved herein contained the following (R. 20, 33-34):

SECTION 1. *Rights of lessee.*—That the lessor, in consideration of rents and royalties to be paid, and the conditions and covenants to be observed as herein set forth, does hereby grant and lease to the lessee the exclusive right and privilege to drill for, mine, extract, remove, and dispose of all the oil and gas deposits except helium gas in or under the following-described tracts of land * * * together with the right to construct and maintain thereupon all works, buildings, plants, waterways, roads, telegraph or telephone lines, pipe lines, reservoirs, tanks, pumping stations, or other structures necessary to the full enjoyment thereof,

for a period of 5 years, and so long thereafter as oil or gas is produced in paying quantities * * *.

On the basis of these facts, the Tax Court, overruling the Commissioner's determination (R. 11-15) in large part, held that the first-year payments made by the taxpayer during the taxable years for the acquisition of the non-competitive Government leases on oil and gas lands were deductible as rentals, rather than non-deductible capital expenditures recoverable through depletion allowances (R. 20-22). At the same time, the Tax Court, for lack of proof to show error, sustained the Commissioner's action in determining that the filing fees paid by the taxpayer were not deductible expenses. The Tax Court thereupon entered its decision accordingly (R. 23), from which the Commissioner petitioned this Court for review (R. 55).

STATEMENT OF POINTS TO BE URGED

The Tax Court of the United States erred (R. 59-60):

1. In holding and deciding that first-year payments made by the taxpayer in 1948 and 1949 in connection with the issuance of non-competitive Government leases on oil and gas lands are ordinary and necessary expenses and deductible under Section 23 (a) of the Internal Revenue Code.

2. In failing to hold and decide that the first-year payments made by the taxpayer in 1948 and 1949 in connection with the issuance of non-competitive Government leases on oil and gas lands should be capital-

ized and recovered through depletion deduction under Section 23 (m) of the Internal Revenue Code.

3. In holding and deciding that the payments made by the taxpayer in the first lease years of the non-competitive leases were "true rentals."

4. In failing to hold and decide that the payments by the taxpayer in the first lease year were in the nature of bonuses or advance royalty.

5. In failing to hold and find that the payments were made for the acquisition of an economic interest in a mineral deposit within the meaning of Treasury Regulations, and represent a capital investment in the property recoverable only through the depletion allowance.

6. In that the opinion and decision are contrary to the law and the Regulations, and are not supported by substantial evidence of record.

7. In ordering and deciding that there are deficiencies in income tax for the years 1948 and 1949 in the respective amounts of \$19.26 and \$122.64.

8. In failing to order and decide that there are deficiencies in income tax for the years 1948 and 1949 in the respective amounts of \$983.72 and \$9,454.06.

SUMMARY OF ARGUMENT

The expenditures for the so-called first-year "rentals" made by the taxpayer in acquiring the non-competitive Government leases on oil and gas lands were in fact consideration paid for the acquisition of an economic interest or equity of indefinite duration in the minerals in place and, therefore, in accordance

with the applicable Treasury Regulations and decisions, they could have represented nothing other than a capital investment in the mineral properties recoverable only through depletion allowances spread over the life of the leases. Although the advance payments in question are termed, variously, rents, rentals and/or royalties in the leases, this is clearly not significant for the pertinent decisions hold that these are all the same in nature and substance as advance royalties and so-called bonuses which the lessee must capitalize and recover through depletion deductions. Moreover, there is no basis whatever in the statute, Regulations or applicable decisions for the Tax Court's erroneous holding that the taxpayer's expenditures for these so-called "rentals" constituted ordinary and necessary business expense rents, within the statutory definition thereof, and deductible as such.

ARGUMENT

The so-called first-year "rentals" in question constituted in fact consideration paid for the acquisition of an economic interest of indefinite duration in the mineral deposits under the noncompetitive leases on the oil and gas lands, and therefore they represented capital investments in the properties recoverable only through depletion allowances spread over the life of the leases

The sole question presented for decision is whether the first-year so-called "rental" payments made by the taxpayer's various partnerships during the taxable years 1948 and 1949 for the acquisition of the noncompetitive Government leases on the oil and gas lands in question constituted consideration paid for

the acquisition of an economic interest of indefinite duration in the mineral deposits in place, which should properly be charged to capital and recovered through annual depletion allowances spread over the life of the leases, under the provisions of Section 23 (m) of the Internal Revenue Code of 1939 (Appendix, *infra*), as interpreted by the Regulations promulgated thereunder, rather than deducted as ordinary and necessary business expenses as held by the Tax Court.

The Tax Court, following its earlier decision in *Featherstone v. Commissioner*, 22 T. C. 763, and also the Tenth Circuit's comparatively recent decision in *United States v. Dougan*, 214 F. 2d 511, resolved the issue in favor of the taxpayers, and held that the so-called rental payments in question were not capital expenditures but constituted true "rentals" deductible as ordinary and necessary business expenses under Section 23 (a) (1) (A) of the 1939 Code (Appendix, *infra*). (R. 21.) In the *Featherstone* case involving the same type of noncompetitive Government leases as here, the Tax Court held that the first-year payments made on the oil and gas leases issued by the United States and various state governments there were likewise deductible as true rentals under Section 23 (a) (1) (A). It so concluded on the ground that the payments there in question should be considered the same in substance as "delay rentals," both purportedly being fixed sums paid to secure for the payor the right to hold the leases for the succeeding year or years without the necessity of drilling wells or making further payments, except royalties on the

minerals produced.¹ In the *Dougan* case, also involving the same kind of leases, the Tenth Circuit, affirming the District Court, had theretofore held that the first-year "rentals" there in question were not depletable capital expenditures but rather non-trade or non-business expenses paid for the production of income or for the management, conservation or maintenance of property held for the production of income, deductible only under Section 23 (a) (2) of the 1939 Code (Appendix, *infra*).² We submit that the Tax Court erred here in following its prior decision in the

¹ Delay rentals are clearly distinguishable from advance royalties and bonuses, the delay rental being a penalty imposed on the lessee by the lease for failure to drill during the current year (*Jefferson Lake Sulphur Co. v. Lambert* (E. D. La.), decided June 29, 1955 (1955 P-H, par. 72,863), as shown hereinafter. Delay rentals, however, are not involved in the present case.

² In *Dougan v. United States* (Utah), decided August 8, 1953 (without opinion), the District Court made findings of fact and conclusions of law (unreported, but may be found in 1953 P-H, par. 72,732) holding that the rentals there in question were not capital expenditures but were deductible as ordinary and necessary business expenses, within the meaning of Section 23 (a) (1) (A), and also as non-trade or non-business expenses paid for the production or collection of income, or for the conservation or maintenance of property held for the production of income, under Section 23 (a) (2); to the same effect is *Hagood v. United States* (Wyo.), decided October 26, 1953 (1953 P-H, par. 72,760), where the District Court tentatively followed the Utah District Court's earlier decision in the *Dougan* case, anticipatory to the Tenth Circuit's finally resolving the issue in both cases. Upon the Tenth Circuit's finally resolving the issue against the Government in the *Dougan* case, no appeal was presented by the Government in either the *Hagood* or the *Featherstone* cases, *supra*—both of which would have gone to that Circuit upon appeal—nor was certiorari to the Tenth Circuit petitioned for by the Government in the *Dougan* case because of the absence of a conflict.

Featherstone case, as well as the Tenth Circuit's decision in the *Dougan* case, both of which we consider to be contrary to the provisions of the pertinent statute, Regulations and decisions cited hereinafter.

The taxpayer contended in the Tax Court that the first-year payments in question were deductible as business expense rentals under Section 23 (a) (1) (A) (R. 21)—that is, in the language of the statute, “rentals * * * required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity,” and as such they were deductible as ordinary rent. It is our position that the amounts of the so-called “rentals” paid during the taxable years involved by the taxpayer's several partnerships in connection with the Government's issuance and their acquisition of the noncompetitive leases on the oil and gas lands were in fact, regardless of the terminology used in describing them in the leases, nothing more or less than “payment made for the acquisition of an economic interest in a mineral deposit * * * [which] constitutes a capital investment in the property recoverable only through the depletion allowance” spread over the life of the leases and deductible for the respective taxable years to which applicable, within the meaning of the statute and interpretive Regulations. Sections 23 (m) of the 1939 Code, as interpreted by Sections 29.23 (m)-1 and 29.23 (m)-10 (a) of Treasury Regulations 111 (all Appendix, *infra*).

First, it is settled that it is the nature and substance of the transaction—not the form as designated and used by the parties—which determines tax incidence, the formal attributes of the taxpayer's lease instruments and the descriptive terminology which may be applied thereto under local law both being irrelevant. *Palmer v. Bender*, 287 U. S. 551, 555; *United States v. Dougan*, *supra* (p. 513). In *Southwestern Hotel Co. v. United States*, 115 F. 2d 686, the Fifth Circuit holding that certain payments made under a lease must be capitalized, stated (p. 688):

The fact that these payments were called “additional rentals” in the lease contract can avail appellant nothing. The character of such payments must be determined in the light of the facts and circumstances surrounding them, and the *character, not the name, must control*. To hold otherwise would defeat the purpose of the act. If the name controlled the fact, this tax could be avoided by the ignorant by chance misnomer, or by the learned by intentional misnomer. [Italics supplied.]

Hence, it is clear that the fact that the payments here in question were called “rentals” in the taxpayer's leases, instead of advance royalties or bonuses, does not in any way affect their treatment for tax purposes. It is equally clear that the term rentals was used in the leases to distinguish such payments from royalties conditioned upon actual production of oil and gas. Payments made prior to production, although in the nature of royalties and considered as royalties for depletion purposes, are referred to, variously, as bonuses, advance royalties or rentals. It is

clear that this distinction has been recognized throughout the Government leases here involved by the use of the term "rents" and "rentals" versus "royalties" to differentiate the payments made or to be made before and after discovery, respectively. (R. 20, 33-34, 36, 39, 45, 53-54.) Hence, it is also clear that there is no real basis in this record for the taxpayer's contention below and the Tax Court's holding that the term "rentals", as technically used in the leases here, nevertheless comes within the statutory definition of ordinary business expense "rentals" as used in and made deductible under Section 23 (a) (1) (A). *Jefferson Lake Sulphur Co. v. Lambert* (E. D. La.), decided June 29, 1955 (1955 P-H, par. 72,863).

Apropos of the foregoing, the Tenth Circuit aptly stated it in the *Dougan* case, *supra* (p. 513), involving like leases and payments, as follows:

If the payments in question are in fact consideration for the cost of the leases to the lessees, they undoubtedly represent the cost of an economic interest in minerals and are therefore depletable capital expenditures. *Sunray Oil Co. v. Commissioner*, 10 Cir., 1945, 147 F. 2d 962; *Canadian River Gas Co., v. Higgins*, 2 Cir., 1945, 151 F. 2d 954. And this is so even though such payments would be ordinary income to a private lessor, *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199; *Sunray Oil Co. v. Commissioner*, *supra*; *Canadian River Gas Co. v. Higgins*, *supra*; or regardless of nomenclature, *Sneed v. Commissioner*, 33 B. T. A. 478; *Kleberg v. Commissioner*, 43 B. T. A. 277; *McFaddin v. Commissioner*, 2 T. C. 395; or local legal characterizations. *Burnet v. Harmel*,

supra; *Palmer v. Bender*, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 512; *Houston Farms Development Co. v. United States*, 5 Cir., 1942, 131 F. 2d 577. It is the nature and substance of the transaction which determines tax incidence, *Palmer v. Bender, supra*.

Under the rules enunciated there and the decisions cited hereinafter we think it well nigh irrefragable that the terms of the leases here clearly show, contrary to the holdings of the Tax Court in the present and the *Featherstone* cases as well as those of the Tenth Circuit in the *Dougan* case, that the controverted payments made by the taxpayer's partnerships in connection with the *acquisition* of the leases plainly constituted consideration paid as part of the cost of the leases, that is, the cost of an economic interest or equity in the oil and gas deposits in place, and that as such they must be capitalized and therefore are recoverable only through annual depletion allowances spread over the life of the leases. Sections 29.23 (m)-1 and 29.23 (m)-10 (a) of Treasury Regulations 111.

Section 1 of the leases here granted to the taxpayer and his co-partner-lessees "the exclusive right and privilege" to drill for, extract and dispose of "all the oil and gas deposits * * * in or under the * * * tracts of land" leased, together with other named rights "necessary to the full enjoyment thereof, for a period of 5 years, and so long thereafter as oil or gas is produced in paying quantities * * *", all of which was "in consideration of rents and royalties to be paid" therefor (R. 20, 33-34, 36), under the

“Rentals and Royalties” schedule attached to the lease (R. 53-54). Further, Section 3 (b) of the leases gave the lessees the right to use whatever surface of any of the lands which might be necessary for their purposes, and reserved to the lessor certain rights including, among other things (R. 43):

The right to lease, sell, or otherwise dispose of the surface of any of the lands embraced within this lease * * * insofar as said surface is not necessary for the use of the lessee in the extraction and removal of the oil and gas therein.

Upon the issuance of the leases, the lessees acquired all oil and gas rights to the properties for three succeeding years without further payments of “rentals” (R. 53-54), at the end of which time they could abandon the leases without incurring any additional liability (R. 45-46). Further, the leases provided for a minimum royalty of \$1 per acre in lieu of subsequent “rentals” for later years but not in lieu of the initial “rental” payments since this former provision applied only to “each lease year after discovery”, and once the leases were issued these initial payments could not be recovered by the lessees regardless of discovery or production. (R. 53-54.) Moreover, the lessees had certain contingent rights in and to the leased oil and gas lands which they could sublet by the “Assignment of [their] oil and gas lease or interest therein”, upon approval of their 90-day notice thereof by the Government, upon the “final execution [of] any instrument of transfer made of this lease, or any interest therein, including assignments of

record title, working or royalties interests, operating agreements and subleases * * *.” (R. 40-41.)³

In the light of these facts, it is clear, we submit, that the payments in question were, contrary to the Tax Court’s holding, not true statutory rentals as defined in Section 23 (a) (1) (A), or otherwise. *Jefferson Lake Sulphur Co. v. Lambert, supra*. Rather they were in fact depletable capital expenditures paid as consideration for the cost of the leases which, under the pertinent statutes, Regulations and decisions, represented the cost of an economic interest or equity in oil and gas in place, recoverable only through depletion allowances. This is obvious for the reason that they were made solely “for the privilege of exploiting the land for the production of oil and gas for a prescribed period”—here for 5 years, or even longer in the event such minerals were produced in paying quantities. (R. 20, 33-34.) *Burnet v. Harmel*, 287 U. S. 103, 107; *Palmer v. Bender*, 287 U. S. 551, 557; *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954, 956-957 (C. A. 2d), certiorari denied, 327 U. S. 793; *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962, 965 (C. A. 10th); *Baton Coal Co. v. Commissioner*, 51 F. 2d 469 (C. A. 3d); *Jefferson Lake Sulphur Co. v. Lambert, supra*; Sections 23 (m) and 114 (b) (3) of the 1939 Code (Appendix, *infra*), as interpreted by Sections 29.23 (m)-1 and 29.23 (m)-10

³ It should be noted that in *Hagood v. United States* (Wyo.), decided October 26, 1953 (1953 P-H, par. 72,760), another lessee of Government oil and gas lands made it a practice, after filing applications, to negotiate with oil operators, drillers or companies, and enter into subleases and other subleasing arrangements.

(a) of Treasury Regulations 111. As noted above, Section 23 (a) (1) (A) specifically excludes from the statutory definition of "rentals" payments made with respect to property to which the taxpayer has taken or is taking title or in which he has an equity.

In this connection, it will also be noted that Section 29.23 (m)-10 (a), of the Regulations referred to above, specifically provides, in respect of "a bonus in addition to royalties * * * received upon the grant of rights in mineral property," that the payee-lessor shall be entitled to specified depletion allowances, and that—

In the case of the payor [lessee] any payment made for the acquisition of an economic interest in a mineral deposit * * * constitutes a capital investment in the property recoverable only through the depletion allowance.

Likewise, Section 29.23 (m)-1 thereof provides that—

the owner of an economic interest in mineral deposits * * * is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place * * * and [upon discovery] secures, by any form of legal relationship, income derived from the severance and sale of the mineral * * *, to which he must look for a return of his capital. * * *

These are reasonable Regulations, clearly not inconsistent with the terms of the statute, and therefore should be given the force and effect of law. *Lykes v. United States*, 343 U. S. 118, 126-127, rehearing

denied, 343 U. S. 937; *Commissioner v. South Texas Co.*, 333 U. S. 496, 501; *Morgan v. Commisisoner*, 309 U. S. 78, 81; *Morrissey v. Commissioner*, 296 U. S. 344, 355. Paraphrasing this Court's holding long ago in connection with a comparable situation involving statutory construction in *Crocker v. Lucas*, 37 F. 2d 275, 277 (1930), the construction thus placed upon the statute by the Treasury Department which is clearly not in conflict with any express provision thereof, has impliedly been recognized by the reenactment of the revenue laws without substantial alteration in the particulars as construed, with nothing in later amendments and/or revisions militating against the construction adopted by the department, and is not plainly erroneous and has been long acquiesced in by the public, should not be overturned or departed from at this late date.

The foregoing Regulations—providing that “any” payment made by the lessee for the acquisition of an economic interest in mineral deposits in place constitutes a capital investment in the property recoverable only through depletion allowances (Treasury Regulations 111, Section 29.23 (m)–10 (a)), and that an economic interest is *possessed* in every case in which the lessee has acquired, by investment, “any” interest in mineral deposits (*id.*, Section 29.23 (m)–1)—are in harmony with and supported by the authoritative decisions. Thus, in *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, where the transfer of rights to the taxpayer-grantee-operator under the oil contract was held to have constituted an assignment to the taxpayer of the right to exploit the prop-

erty with a reservation in the assignor of an economic interest in the oil, the Supreme Court stated (pp. 34-35, 37):

It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil. See Kirby Petroleum Co. v. Commissioner [326 U. S. 599], supra, page 604. [Italics supplied.]

* * * * *

It [the assignor's assignment] is rather an assignment to the operator, petitioner [grantee] here, of the right to exploit the property with a reservation in the assignor of an economic interest in the oil.

In *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954, the Second Circuit held (p. 956) that advance royalties or so-called bonuses—"similar to rentals * * * which the lessee must capitalize"—paid by the lessees upon the execution of the leases were not deductible currently as expenses but were capital expenditures to be recovered only through depletion allowances. The court stated (pp. 956-957):

What the lessor gets *for* the lease and how that should be taxed does not control decision as to the character of what the lessee gets *under* the lease. *Just as advance royalties may be consideration for a lease and also ordinary income to the lessor, Burnet v. Harmel, supra, they may be capital investments by a lessee when paid for capital assets. They are analogous to rentals that are taxable as income to a*

landlord though *they may be bonuses or advances which the lessee must capitalize*. *Baton Coal Co. v. Commissioner*, 3 Cir., 51 F. 2d 469. So it does not follow, as the plaintiff argues, that because the advance royalties are taxable as ordinary income to the lessors *the lessee did* not make a capital investment when it paid them in consideration for the leases. In *Helvering v. Bankline Oil Co.* [303 U. S. 362], *supra*, the taxpayer had but a contract right to process certain wet gas at the casingheads and was held to have no depletable interest but only an economic advantage not an asset subject to an allowance for depletion. By way of contrast it should be noticed that the present plaintiff acquired the right to exploit the property by drilling wells and operating them to produce whatever it could from the gas in the ground. *The cost of those leases, i. e., the advance royalties, was part of the capital it had to invest before production started, was the consideration paid for an economic interest in the gas bearing land leased. It thereby obtained an asset which was depletable* not because of the existence of the arbitrary depletion method of Sec. 114 (b) (3) but *because it was a wasting capital asset which was inherently depletable. The advance royalties instead of being paid as a part of the purchase price of gas bought for resale were paid as the consideration for the conveyance of a leasehold in which the plaintiff invested to obtain the right to produce gas from the land leased. Cf. Burton-Sutton Oil Co. v. Commissioner*, 5 Cir., 150 F. 2d 621. It would be plain enough that these payments would have been capital ex-

penditures had they been made for the fee. They were, we think, none the less so because only a leasehold was obtained. [Italics supplied.]

Likewise, in *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962, the Tenth Circuit held (p. 966) that bonuses or advance royalties paid by the taxpayers to the State of Oklahoma for oil and gas leases represented cost to the lessees and were capital expenditures to be recovered through depletion. The court pointed out that to allow these payments as current deductions from gross income would be, in effect, to allow double deductions, that is, cost depletion in addition to percentage depletion, by reason of the fact that had the taxpayers elected to take cost depletion, the bonuses or advance royalties would have been included in the base for cost depletion. The court there stated (p. 966):

While advance royalties are regarded as income to the lessor, with respect to the lessee, they represent cost and are a capital expenditure.¹⁴ *There is no incongruity in the view that a bonus and royalty are "consideration for the lease, and are income of the lessor."* *Burnet v. Harmel, supra*, 287 U. S. 103 at page 112, 53 S. Ct. at page 77, 77 L. Ed. 199. Not infrequently, payments made for an article constitute a capital investment by the payor, but income to the recipient. Where a manufacturer processes raw materials and constructs therefrom a finished product, and sells such product, the whole of the purchase price may be a capital investment by the purchaser, but, to the extent

it exceeds the cost of goods sold, it is gross income to the manufacturer.¹⁵ It is significant that in the accounting practices of 30 of the 32 principal companies engaged in the production of oil, *an advance royalty is treated from the payor's standpoint as a capital investment.*¹⁶ [Italics supplied.]

¹⁴ *Baton Coal Co. v. Commissioner of Internal Revenue*, 3 Cir., 51 F. 2d 469, 470; *Law of Federal Income Taxation*, Mertens, Vol. 2, Sec. 12:31; *Id.*, Vol. 4, Sec. 25.22.

¹⁵ See *United States v. Ludey*, 274 U. S. 295, 302, 47 S. Ct. 608, 71 L. Ed. 1054; Art. 22 (a)-5, Tr. Reg. 101.

¹⁶ *Depletion in the Oil Industry*, Paul Forasté (1943), p. 9.

Also, in the recent case of *Jefferson Lake Sulphur Co. v. Lambert* (E. D. La.), decided June 29, 1955 (1955 P-H, par. 72, 863), the District Court, holding that the taxpayer-lessee's quarterly payments made during the primary term of the sulphur lease there were not deductible as statutory "rentals" under Section 23 (a) (1) (A) as claimed by the taxpayer, stated:

The quarterly payments in suit were not delay rentals since they were to be paid irrespective of production from the property. * * * unquestionably, the taxpayer here, when he acquired the right to go on the property and mine sulphur, obtained an economic interest or equity in the minerals in place in that land. *Burton-Sutton Oil Co. v. Commissioner*, *supra*, p. 34-35. Consequently, the quarterly payments do not come under the statutory definition of rent and are not, therefore, deductible as such.

Apropos of the foregoing "economic interest" test as set forth in the above-mentioned Regulations and decisions, this Court in *Commissioner v. Southwest Exploration Co.*, 220 F. 2d 58, affirming the decision of the Tax Court (18 T. C. 961), and holding that the taxpayer, which had paid over to the upland owners for easements-to-drill sites 24½% of its net profits, nevertheless owned the entire capital interest in the oil deposits there involved under its agreement with the State of California, and therefore was entitled to the depletion deductions for the extracted off-shore oil,⁴ stated as follows (pp. 60-61, 62):

* * * the depletion deduction is allowable only to those who have a capital investment or economic interest in the oil or other mineral in place from which income is received by reason thereof. *Kirby Petroleum Company v. Commissioner*, 326 U. S. 599 * * *; *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U. S. 25 * * *; *Helvering v. Bankline Oil Company*, *supra* [303 U. S. 362]; *United States v. Spalding* (9 Cir.), 97 F. 2d 701. In determining whether a taxpayer has such an investment or interest no significance attaches to the particular legal form of the transaction creating the rights. *Burton-Sutton Oil Co., Inc. v. Commissioner*, *supra*; *Palmer v. Bender*, 287 U. S. 551 * * *; *Lynch v. Alsworth-Stephens Co.*, 267

⁴ The Court of Claims held in *Huntington Beach Co. v. United States*, decided July 12, 1955 (1955 P-H, par. 72, 835), however, that the depletion was allowable to the adjoining land owners on the profit payments from the off-shore oil production. Both cases are now pending in the Supreme Court on the Government's petitions for certiorari filed August 2, 1955.

U. S. 364 * * *. It is enough that the taxpayer has acquired through any form of legal relationship the right to share in the oil produced. *Palmer v. Bender, supra*. And a right to share in the profits from the sale of the oil following extraction is analogous to a right to share in the mineral itself. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312 * * *; *Anderson v. Helvering, supra* [310 U. S. 404]; *Kirby Petroleum Company v. Commissioner, supra*; *Burton-Sutton Oil Co., Inc. v. Commissioner, supra*. * * *

* * * * *

* * * in so far as the 835 acres here involved are concerned, any present economic interests therein were acquired by virtue of, and simultaneously with the Agreement for State Easement No. 392 or through some transaction subsequent thereto.

The State and petitioner were the only parties to the body of this agreement. The granting clause therein granted to the petitioner the sole and “* * * exclusive right to drain, take, receive, extract, remove, and produce from the * * * lands, oil, gas, and other hydrocarbon substances * * *.” This right is not made subject to any pre-existing rights and there is no provision therein for income derived from oil production to be shared with third parties. Within its four corners, then, it would appear that such economic interests as were passed therein, were acquired by petitioner alone. * * *

In summation, then, it is our view that petitioner was the sole recipient under the Agreement for State Easement No. 392 of an economic interest in the oil property involved; * * *

While the issue involved in that case is not involved here, nevertheless the rules in respect of the economic interest in the oil in place acquired by the taxpayer in its agreement with the State of California, as laid down by this Court there, are equally applicable here in respect of the taxpayer's acquisition of an economic interest in the oil and gas in place under his agreements (non-competitive leases) with the United States.

In harmony with the foregoing, the Tax Court itself, contrary to its holding here (R. 21) and in the *Featherstone* case (p. 771), has held in a series of cases that annual "rentals" and analogous payments made for leases on oil, gas, ore, etc., lands constituted payments made in consideration of an economic interest in minerals in place. See *McFaddin v. Commissioner*, 2 T. C. 395, 404-405, affirmed in part and remanded without discussion on this point, 148 F. 2d 570 (C. A. 5th), holding that "Royalties and bonuses under oil, gas, and mineral leases have some resemblance to rentals," and that annual payments called "rentals," due and payable in advance were "in the nature of advance royalties" or "guaranteed minimum royalties", in accord with its previous holding in *Kleberg v. Commissioner*, 43 B. T. A. 277, where it was held (pp. 289-294) that the lessee's payments on the oil and gas lands leased for production there constituted a bonus in the nature of advance royalties, notwithstanding that the amount, paid in two installments, was calculated on the basis of certain annual payments for 20 years discounted at their present value; *Westates Petroleum Co. v. Commissioner*, 21 T. C. 35, 39, holding, on the authority of

Sunray Oil Co. v. Commissioner, supra, that “A cash bonus payment paid as consideration for such a lease [for the right, for one year, to enter into and explore and drill for oil and gas on the leased property] is regarded as advance royalties * * * and must similarly be classified as a bonus paid to obtain the option” therefor; *Kittle v. Commissioner*, 21 T. C. 79, 88, holding that the advance payments there required of the lessee under the lease of iron ore lands were identical in character with and therefore represented advance royalties or cash bonus payments, as in *Burnet v. Harmel*, 287 U. S. 103, and *Bankers Coal Co. v. Burnet*, 287 U. S. 308; *Patch v. Commissioner*, decided December 13, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41,552), holding that the annual rental there which was to be received by the lessor regardless of drilling or production constituted an advance royalty.

Nor is there any basis in the statute, Regulations or decisions for the Tax Court's holding here, as in the *Featherstone* case (p. 771), that only “rentals” paid in respect of a year in which minerals were produced in paying quantities constitute capital expenditures recoverable through depletion deductions (R. 21). It is settled, as pointed out, that advance royalties or so-called bonuses—essentially “analogous to rentals * * * which the lessee must capitalize” (*Canadian River Gas Co. v. Higgins, supra*, p. 956)—represent capital payments paid in advance upon the execution of leases for oil and gas *to be extracted*, even though there was no production when the leases were made or at any time within the taxable year, and

that the depletion deduction is not based exclusively upon the actual production of minerals in that year. *Herring v. Commissioner*, 293 U. S. 222; *Burton-Sutton Oil Co. v. Commissioner*, *supra* (pp. 34-35, 37); *Burnet v. Harmel*, *supra* (p. 107). While the lessor may take percentage depletion deductions on bonuses and advance royalties when received, and the lessee must capitalize such payments (Treasury Regulations 111, Sec. 29.23 (m)-10 (a)), yet if the lease later proves unproductive, the lessor must restore such previous deductions to the income of the year of abandonment of the property (*id.*, Sec. 29.23 (m)-10 (c), Appendix, *infra*; *Douglas v. Commissioner*, 134 F. 2d 762 (C. A. 8th)), and the lessee is entitled to deduction of the full amount of the payments made on the lease as an abandonment loss at the time of the termination or abandonment of the lease. On the other hand, if the lease turns out to be productive, the advance payments, initially capitalized, are recoverable through depletion allowances to the lessee. Hence, the taxpayer-lessee here is not entitled to deductions of the first-year "rentals" payments as business expense under Section 23 (a) (1) (A) for that would amount to a double deduction which is not permissible under any circumstances. *Id.*, Sec. 29.23 (a)-1, Appendix, *infra*; *Sunray Oil Co. v. Commissioner*, *supra* (pp. 966-967); *Canadian River Gas Co. v. Higgins*, *supra* (p. 956); *Jefferson Lake Sulphur Co. v. Lambert*, *supra*.

In these circumstances, it is difficult to perceive how anyone, in the light of the above-cited controlling decisions, could properly say that advance payments

such as the taxpayer's so-called rentals could possibly have represented anything other than capital investment recoverable through annual depletion deductions spread over the life of the oil and gas leases. Yet the Tenth Circuit did so in its adverse decision in *United States v. Dougan*, *supra* (p. 514), despite its own previous decision in the *Sunray Oil Co.* case, *supra* (p. 966) holding to the contrary. In the *Sunray* case, it had held, as pointed out, that advance royalties and bonuses paid by the lessee represented cost and were capital expenditures because they were consideration for the lease and therefore were properly treated from the payor's standpoint as capital investment. As against this, the court nevertheless held in respect of the first-year advance rentals in the *Dougan* case (p. 514) that—

A consideration of the applicable statutes, regulations and leases issued in conformity therewith leads us to the conclusion that Congress intended to draw a clear distinction between bonuses and advance royalties paid as a consideration for competitive leases and first-year rentals on non-competitive leases granted to the first qualified applicant on payment of the prescribed filing fee. With respect to the latter leases, we think Congress intended a free-grant lease in consideration for the prescribed filing fee, conditioned upon the payment of the first-year and subsequent stipulated rentals until after discovery. After discovery upon the leased lands the lessee becomes obligated to pay a minimum royalty in lieu of rentals.

We are unable to find any *real* basis or authority—and, it will be noted, the Tenth Circuit furnished none—for the court's purported distinction, said by it to have been intended by Congress,⁵ between advance royalties, bonuses and so-called rentals *paid as consideration for competitive* leases on the one hand and *non-competitive* leases on the other, other than the manner and legal procedure by which they are acquired. In either event, the payments made in connection with the acquisition of the leases constitutes part of the purchase price. Moreover, the attempted distinction flies directly in the teeth of the rule laid down by the Supreme Court in the *Burton-Sutton Oil Co.* case, *supra* (pp. 34-35, 37), and other related cases above-cited, namely, that it is the lessee's *possibility of profit* from the use of his right to exploit the property under the lease which marks his economic interest or equity in the minerals in place. It is also directly contrary to the specific provisions of the above-cited Regulations (Secs. 29.23 (m)-10 (a) and 29.23 (m)-1 of Treasury Regulations 111) providing that "any" payment—advance royalty, bonus, so-called rentals, etc., by whatever name called—made by the lessee for the *acquisition of* an economic interest in mineral deposits constitutes a capital investment in the property recoverable only through the depletion allowance. Hence, insofar as

⁵ As the Fifth Circuit aptly held in *Commissioner v. Gracey*, 159 F. 2d 324, 325, "we may not speculate as to what Congress might have contemplated or intended. We must construe and apply the law as it is written", citing *Sabine Transp. Co. v. Commissioner*, 128 F. 2d 945, (C. A. 5th), affirmed 318 U. S. 306, and *Helvering v. Credit Alliance Corp.*, 316 U. S. 107.

the statute, Regulations and applicable decisions disclose, there is no conceivable, or indeed possible, difference between the essential nature and character of advance royalties, bonuses and/or so-called rentals paid by the lessee in connection with the acquisition of and as consideration for competitive versus non-competitive leases embracing minerals in place. Unaccountably, moreover, the Tenth Circuit gave support to this conclusion by holding in the *Dougan* case (p. 514) that "Surely the [non-competitive] leases were property rights in which the lessees were taking title or in which they held some equity", which is in harmony with the above-cited statute, Regulations and controlling decisions.

At that point, however, the Tenth Circuit, in the *Dougan* case, veered off in another direction whereby it arrived at its adverse conclusion (p. 515) transmuting nondeductible capital items, the so-called first year rentals there, into non-business expense items deductible not under Section 23 (a) (1) (A) but only under subsection (a) (2) thereof as ordinary and necessary expenses paid or incurred during the taxable years for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income. In so holding the court said (p. 514) that it could find no warrant for the District Court's conclusion in the *Dougan* case that the first-year rental payments there were made as a condition for the continued use or possession of property, title to which the taxpayers had not taken or were not taking or in which they had no equity. Thus the court thereby nega-

tived the District Court's holding that the rentals in question were also deductible as ordinary and necessary business expenses under Section 23 (a) (1) (A). This, in turn, operates as judicial authority against the Tax Court's holdings of the deductibility of analogous "rentals" under that section here and in the *Featherstone* case.

The District Court, holding in *Jefferson Lake Sulphur Co. v. Lambert, supra*, that the taxpayer-lessee's quarterly payments there were not deductible under Section 23 (a) (1) (A) because they did not come within the statutory definition of "rentals" therein, stated further that the *Dougan* and *Featherstone* cases, in the light of the decision in *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, were not persuasive in holding that the first-year "rentals" under the leases there were deductible instead of chargeable to capital investment—as above indicated. The reason assigned therefor by the District Court was as previously pointed out, that "unquestionably", under the rule laid down by the Supreme Court in the *Burton-Sutton Oil Co.* case, *supra* (pp. 34-35) the taxpayer in the *Jefferson Lake Sulphur* case, upon acquiring the right to go on the property and mine sulphur, thereby obtained a real economic interest or equity in the minerals in place in that land, and therefore the lessee's quarterly payments were not, contrary to the holdings of the Tax Court here and in the *Featherstone* case, deductible as business expense "rentals" under Section 23 (a) (1) (A). But the District Court thereupon likewise swerved

off in another direction and held, purportedly on the authority of the *Burton-Sutton Oil Co.* case, *supra*,⁶ that since, under the authorities, the quarterly payments there were depletable as advance royalties by the lessor, they were in turn excludible from income as advance royalties by the lessee. It so held despite the fact that this result left no adequate capital basis to support statutory depletion allowances on the proceeds from the minerals produced from the leasehold which the taxpayer had been claiming for many years. This, however, it held, was a matter which was not the concern of the court or the Commissioner in the purported absence of "the need in law for such basis [which] does not clearly exist." In so deciding the case, the District Court declined to follow the Second, Third, Fifth and Tenth Circuits' decisions in *Canadian River Gas Co. v. Higgins*, *supra*, *Baton Coal Co. v. Commissioner*, 51 F. 2d 469; *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588,⁷ and *Sunray Oil Co. v. Commissioner*, *supra*,⁸ respec-

⁶ The District Court conceded that the grantee-operator's payments to the owner-lessor in the *Burton-Sutton Oil Co.* case were not characterized as and in fact were materially different from bonuses and advance royalties, and therefore that "that case may be distinguishable * * * on its facts." Nevertheless, it stated that "the principle there applied is applicable here" and thereupon found and applied a newly-devised principle of its own without statutory basis therefor, as shown hereinafter.

⁷ The District Court stated in the *Jefferson Lake Sulphur Co.* case (fn. 10) that while the Fifth Circuit "seems" to have held in the *Quintana* case that advance royalties are not excludible from income by the lessee, yet it later "apparently" admitted in *Commissioner v. Gracey*, 159 F. 2d 324, that its decision in the *Quintana* case was contrary to the principles approved by the Supreme

tively, on the ground that those cases, ostensibly, were inconsistent with the principles enunciated by the Supreme Court in certain specified decisions, particularly *Burton-Sutton Oil Co. v. Commissioner, supra*. In the light of what has been said before, however, it is clear that the District Court erred in allowing the taxpayer-lessee deductions for the quarterly payments there in question as advance royalties excludible from income, in the absence of any stated or existing provision in the statute providing therefor, and that its decision in this respect is otherwise directly contrary to the specific provisions of the statute and applicable Regulations as well as the *controlling* decisions heretofore cited.

In these circumstances, it follows, we submit, that since the controverted "rental" payments here unquestionably constituted capital expenditures recoverable only through depletion allowances spread over the life of taxpayer's leases, they may not properly be treated as ordinary and necessary business expenses deductible under Section 23 (a) (1) (A), as erroneously held by the Tax Court.

Court in the *Burton-Sutton Oil Co.* case. A reading of the *Gracey* decision shows that the Fifth Circuit reversed and remanded that case to the Tax Court for a redetermination of the issue—whether the share of the taxpayer's profits paid under the oil lease assignment, adjusted for depletion, was deductible—in accordance with the Supreme Court's decision in the *Burton-Sutton* case. It fails to disclose, however, that the Fifth Circuit there conceded, directly or indirectly, that its decision under the facts of the *Quintana* case was contrary to the rule of the *Burton-Sutton* case, nor did it even mention the *Quintana* case therein.

Nor, in any event, alternatively, is there anything in the record showing that the first-year payments in question were paid or incurred by the taxpayer in carrying on any trade or business during the taxable years involved. Neither does the record disclose that he was carrying on any trade or business incident to oil and gas leases, or that he was engaged in any pursuit or occupation to which he contributed the major or a substantial part of his time for the purpose of a livelihood or profit during the taxable years in which these payments were made, as required by the statute in order to be deductible. *Snyder v. Commissioner*, 295 U. S. 134; *Higgins v. Commissioner*, 312 U. S. 212. At best, in so far as the record shows, the taxpayer, together with his partners, was engaged solely in a series of a few isolated transactions whereby he made investments in oil and gas leases but this, needless to say, did not constitute carrying on a trade or business within the rule of the *Higgins* case, *supra*. Hence, even *assuming* that the payments in question were ordinary statutory "rentals" within the definition thereof in Section 23 (a) (1) (A), as the Tax Court held, nevertheless, contrary to its holding, the provisions of that section are clearly not applicable here, as shown immediately above, and as the Tenth Circuit held in respect of like first-year rentals in the *Dougan* case (pp. 514-515).

In view of the foregoing, we submit that the taxpayer's first-year "rental" payments here in question clearly were not ordinary and necessary business expenses deductible under Section 23 (a) (1) (A), but

solely part of the purchase price of the leases paid as consideration for the acquisition of an economic interest or equity in the mineral deposits in place under the several leases during the taxable years involved, and therefore capital expenditures, within the meaning of the pertinent statutes, Regulations and controlling decisions heretofore cited. Consequently, it is clear that the Tax Court erred in holding that the disputed payments were ordinary and necessary business expenses deductible as true "rentals" under Section 23 (a) (1) (A) of the 1939 Code.

CONCLUSION

The decision of the Tax Court is erroneous in that it is directly contrary to the terms of the applicable statute, Regulations and controlling decisions, and therefore it should be reversed and judgment entered for the Commissioner upon review by this Court.

Respectfully submitted.

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A P P E N D I X

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according

to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum

of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 1952 ed., Sec. 114.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23 (a)-1. *Business expenses*.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (z), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. * * *

SEC. 29.23 (a)-10. *Rentals*.—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum for each year, based on the number of years the lease has to run. * * *

* * * * *

SEC. 29.23 (m)-1. [As amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements*.—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed with respect to any timber which the owner has disposed of under any form of contract by virtue of which the owner retains an economic interest in such timber, if such disposal is considered a sale of the timber under section 117 (k) (2) of the Code. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. * * *

When used in these sections (29.23 (m)-1 to 29.23 (m)-28, inclusive) covering depletion and depreciation—

* * * * *

(b) A “mineral property” is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes

of mineral extraction. The value of a mineral property is the combined value of its component parts.

(c) The term "mineral deposit" refers to minerals in place. The cost of a mineral is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

(d) "Minerals" include ores of the metals, coal, oil, gas, and such nonmetallic substances as abrasives, asbestos, asphaltum, * * * barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, * * * limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, * * * sulphur, talc, * * *.

* * * * *

SEC. 29.23 (m)-10. *Depletion—Adjustments of Accounts Based on Bonus or Advanced Royalty.*—(a) If a bonus in addition to royalties is received upon the grant of rights in mineral property, there shall be allowed to the payee as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received. In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance.

(b) If the owner of operating rights in mineral property for a term of years is required

to extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or to pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the premises, the payee shall treat an amount equal to that part of the basis for depletion allocable to the number of units so paid for in advance of extraction as an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any grant of mineral rights expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the grantor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which such expiration, termination, or abandonment occurs.

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